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C O N F I D E N T I A L BUENOS AIRES 001080

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TREASURY FOR CLAY LOWERY, NANCY LEE, AJEWEL, WBLOCK, LTRAN
NSC FOR JOSE CARDENAS, ROD HUNTER
PASS FED BOARD OF GOVERNORS FOR RANDALL KROSZNER, PATRICE
ROBITAILLE
PASS EXIM BANK FOR MICHELE WILKINS
PASS OPIC FOR JOHN SIMON, GEORGE SCHULTZ, RUTH ANN NICASTRI
USDOC FOR 4322/ITA/MAC/OLAC/PEACHER

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TAGS: [EFIN](#) [ECON](#) [EINV](#) [AR](#)

SUBJECT: FED GOVERNOR KROSZNER IN ARGENTINA; HIGHLIGHTS
GLOBALIZATION'S IMPACT ON CAPITAL MARKETS

REF: BUENOS AIRES 1008

Classified By: Ambassador E.A. Wayne for Reasons 1.4 (b,d)

Summary

11. (C) Fed Governor Kroszner highlighted globalization's impact on international capital flows and yield curves in speeches and roundtable meetings with central bank, government, and private sector representatives during his May 15-16 visit to Buenos Aires. Issues raised during roundtables included: 1) the more diversified world economy and the chances for a soft landing in the U.S.; 2) flattening of yield curves; 3) economic challenges facing China; 4) criticism of the EMBI plus measurement of risk; 5) the importance of trade liberalization; 6) negative externalities related to high commodity prices and excess liquidity; and 7) emerging economies' accumulation of reserves. End Summary.

Kroszner Visit to Argentina

12. (SBU) U.S. Federal Reserve Governor Randall Kroszner visited Buenos Aires, May 15-16, meeting with central bank, government, and private sector representatives and focusing on the impact of globalization on international capital flows and yield curves in speeches and roundtable meetings (see septel for private meetings with Central Bank President and Ref A for separate meeting with Economy Minister).

Speeches highlight beneficial impact of globalization

13. (SBU) On May 15 at the Central Bank, Governor Kroszner gave a speech titled, "International Capital Flows and the Emerging Market Economies." He analyzed the recent trend of

increasing net capital flows from emerging markets to industrial countries, the opposite of previous decades. He noted that this was not in the long-term interest of emerging economies and highlighted ways that emerging-market economies could enhance their prospects for domestic capital formation and financial investment, and position their economies to take advantage of the productivity enhancements brought about by the IT revolution.

¶4. (SBU) His recommendations included: 1) improving regulatory and property rights protection to foster investment necessary to increase productivity; 2) adopting global best practices for financial supervision to promote prudent risk management and effective intermediation; 3) making labor markets more flexible to allow reallocation of resources in response to changes in demand; 4) increasing transparency and disclosure; and 5) ensuring price-stability through appropriate macroeconomic policies.

¶5. (SBU) On May 16, Governor Kroszner gave a speech at the local NGO, "Center for Financial Stability" ("CEF"), titled, "Globalization and Capital Markets: Implications for Inflation and the Yield Curve." He highlighted that globalization, deregulation, and financial innovation had fostered currency competition and improved central bank performance and resulted in the recent reduction of worldwide inflation, particularly in emerging economies. He also emphasized that the taming of inflation and the improved credibility of central banks have been crucial to the deepening of domestic capital markets, which is typically associated with higher economic growth. The result has been the development of longer-term bond markets in many countries and the flattening of yield curves world-wide.

¶6. (U) Both speeches (available on the Federal Reserve website, www.federalreserve.gov) received wide and positive coverage in both the domestic and foreign press.

Highlights of Meetings with GoA and Private Sector

¶7. (SBU) Given Governor Kroszner's focus on globalization, financial markets, and yield spreads, most participants in roundtables at the Central Bank and CEF, and also at a lunch hosted by the Ambassador, focused their questions and comments on perceived risks in international markets.

-- World and U.S Economy: Kroszner pointed out that the world economy was becoming more diversified, with distinct business cycles enabling large parts of the world economy to continue growing even as the U.S. economy slows. He noted that the slowdown in housing and auto sectors were the key challenges to a soft landing for the U.S., but said the housing transition was so far relatively orderly, and predicted a return to the potential growth rate towards the end of 2007.

-- U.S. Housing Sector: The key to the housing sector is working off the large inventory, and the problems so far are mainly in the sub-prime mortgage area -- comprising 14% of the \$9 trillion mortgage market. In that category, the problem area is mostly with variable rate mortgages, comprising only 9% of the mortgage market. So far there appears to be minimal spillover to credit cards or other lending vehicles, and liquidity had not dried up in the sub-prime market. From a macro standpoint, Kroszner said this would not have a major impact. However, he noted that the FED had a consumer protection mandate and wanted people to be able to keep their homes. Aside from the housing sector, Kroszner thought the U.S.' fiscal deficit of 2% of GDP was manageable and the current account deficit of 6-7% was beginning a gradual transition with the weaker dollar.

-- Flattening Yield Curves: Kroszner reviewed recent developments in emerging-market financing, with many countries issuing long-term, fixed-rate bonds issued in domestic currencies. He noted how this had altered the distribution of risks in the global financial system, with

lenders increasingly bearing both exchange and interest rate risks. The flattening/inversion of yield curves is a global phenomenon, and Kroszner attributed the declining yields and lower spreads to global currency competition, more open capital markets, excess liquidity, lower international volatility, and more credible macroeconomic and financial policies. (Note: both local press and international wire services picked up on Kroszner's message that globalization was leading to flatter yield curves).

-- The JP Morgan Chase representative raised concerns about China's economic stability, noting that its highly leveraged stock market left it vulnerable to external shocks. Kroszner agreed that China would not grow at a 10% rate forever, and lower growth would expose difficult problems, such as the banking sector's high non-performing loan rate. Lower growth would also complicate the government's efforts to manage expectations of the population, specifically in rural areas where the desire to move to the coasts is strong. He noted that China needed to pursue policies leading to more balanced growth.

-- Renowned Argentine economist Miguel Angel Broda, a regular critic of GoA economic policies, argued during the Ambassador's lunch that JP Morgan's EMBI plus sovereign bond rating index was no longer a good measure of risk anymore, because emerging market economies' debt levels were, for the most part, sustainable. In his opinion, the EMBI and rating agencies did not adequately measure other, more serious risks, such as inadequate rule of law.

-- Kroszner highlighted continued trade liberalization as one of the most important factors going forward for the world economy. He saw it as a good sign that the U.S. Congress and USG had reached agreement on the Peru and Panama FTAs, but hoped for progress in the Doha round.

-- A negative externality of historically high commodity prices and a surfeit of global capital market liquidity, Kroszner argued, is that the consequent high growth is covering sins, undermining good long-term policies, and weakening reformers in many countries. In the Americas, Kroszner commented that bad policy making in Venezuela, Ecuador, Bolivia, and some other countries, enabled in part by high export revenues, was a negative long-term development and would eventually impact growth and prosperity in the region. Kroszner also worried that excess liquidity in the world economy -- defined as lower spreads, indicating lower risk premiums -- was a disincentive to lenders to do appropriate due diligence on riskier issuances.

-- During the Ambassador's lunch, Kroszner noted that many economists around the world were questioning many emerging market countries' huge reserve accumulations, driven by their policies of maintaining undervalued nominal exchange rates. He commented that it was unusual and inefficient to hold such a huge percentage of GDP sitting in low-interest earning accounts. Responding to Kroszner's comment that the U.S. maintained only minimal reserve levels, Argentine Central Bank President Martin Redrado responded, "unfortunately, we are not the FED, so need to work harder -- and accumulate reserves -- to gain the confidence of markets." Redrado noted that Argentina, like many other countries, was slowly diversifying its reserve holdings out of dollars, seeking 20-25% in Euros and other currencies.

18. (U) Federal Reserve Governor Randall Kroszner did not clear this cable.
MATERA